

**Prospect Harbor Credit  
Partners, L.P.  
Consolidated Financial Statements  
December 31, 2009**

**Report of Independent Auditors**

To the Partners of Prospect Harbor Credit Partners, L.P.

In our opinion, the accompanying consolidated statement of assets, liabilities and partners' capital, including the condensed consolidated schedule of investments, and the related consolidated statements of operations, consolidated changes in partners' capital and of consolidated cash flows present fairly, in all material respects, the financial position of Prospect Harbor Credit Partners, L.P. (the "Partnership") at December 31, 2009, and the results of its operations, changes in its partners' capital and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the General Partner. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit of these financial statements in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by the General Partner, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

*PricewaterhouseCoopers LLP*

March 16, 2010

# Prospect Harbor Credit Partners, L.P.

## Consolidated Statement of Assets, Liabilities and Partners' Capital

December 31, 2009

### Assets

Investments, at fair value (cost \$1,946,366,964)	\$ 1,875,592,604
Cash and cash equivalents	595,690,035
Restricted cash for total return swaps	46,860,848
Restricted cash for credit default swaps	50,629,465
Restricted cash for securities sold short	12,060,000
Restricted cash	10,000,000
Credit default swaps, at fair value (cost \$9,660,390)	3,182,716
Receivable for investments sold	167,264,095
Interest receivable	19,360,390
Unrealized appreciation on forward currency contracts	2,396,786
Receivable for principal paydowns	44,884
Other assets	452,409

### Total assets

\$ 2,783,534,232

### Liabilities

Securities sold short, at fair value (proceeds \$11,610,000)	\$ 12,119,999
Credit default swaps, at fair value (proceeds \$1,243,823)	23,763,418
Unrealized depreciation on total return swaps	2,876,063
Unrealized depreciation on interest rate swaps	221,201
Notes Payable	615,392,464
Senior Facility	242,776,661
Second Senior Credit Agreement	20,406,496
Due to broker - margin	487
Payable for investments purchased	204,448,573
Payable for net realized loss on total return swaps	26,615,633
Interest payable	5,519,269
Capital withdrawals payable	162,158,351
Management fee payable	200,625
Accrued expenses and other liabilities	7,179,118

### Total liabilities

1,323,678,358

### Commitments (Note 15)

### Partners' capital

1,459,855,874

### Total liabilities and partners' capital

\$ 2,783,534,232

The accompanying notes are an integral part of the consolidated financial statements.

# Prospect Harbor Credit Partners, L.P.

## Consolidated Statement of Operations

For the year ended December 31, 2009

### Investment Income

#### Income:

Interest (net of withholding taxes of \$25,385)	\$ 88,436,564
Dividends and other income	10,870,679

<b>Total investment income</b>	<b>99,307,243</b>
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#### Expenses:

Management fee	13,663,000
Professional fees and operating expenses	1,371,977
Credit protection fee	12,343,828
Dividend and interest expense on securities sold short	161,979
Interest expense	9,659,683

<b>Total expenses</b>	<b>37,200,467</b>
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<b>Net investment income</b>	<b>62,106,776</b>
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### Net realized and unrealized gains and losses

Net realized loss on investments and securities sold short (net of withholding taxes of \$104,751)	(21,567,903)
Net realized loss on swap contracts	(231,448,201)
Net realized loss on foreign currency transactions	(7,508,093)
Net change in unrealized appreciation of investments and securities sold short (net of increase in deferred withholding taxes of \$349,119)	614,725,174
Net change in unrealized appreciation from foreign currency translation	(1,032,280)
Net change in unrealized appreciation of swap contracts	359,669,444
Net change in unrealized appreciation of forward currency contracts	(1,082,961)
<b>Net realized and unrealized gains and losses</b>	<b>711,755,180</b>

<b>Net increase in partners' capital resulting from operations</b>	<b>\$ 773,861,956</b>
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The accompanying notes are an integral part of the consolidated financial statements.



**Prospect Harbor Credit Partners, L.P.**  
**Consolidated Statement of Changes in Partners' Capital**  
**For the year ended December 31, 2009**

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	<b>Limited Partners *</b>	<b>General Partner</b>	<b>Total</b>
<b>Balance at January 1, 2009</b>	\$ 805,608,397	\$ 42,539,065	\$ 848,147,462
Contributions	-	-	-
Withdrawals	(161,784,697)	(368,847)	(162,153,544)
Management Fee, net	(13,663,000)	-	(13,663,000)
Carried Interest	-	-	-
Allocation of net increase in partners' capital resulting from operations (excluding management fee and carried interest)	747,812,723	39,712,233	787,524,956
<b>Balance at December 31, 2009 **</b>	<b>\$ 1,377,973,423</b>	<b>\$ 81,882,451</b>	<b>\$ 1,459,855,874</b>

**Year End information**

\* Included in the limited partners' capital account balance at December 31, 2009 is \$169,298,596, which relates to limited partners who are members of the Sankaty Group. The Investment Advisor has waived the management fees with respect to these limited partners for the year ended December 31, 2009.

\*\*At December 31, 2009, one limited partner held over 10% of partners' capital of the Partnership. In total, the limited partner held 11.0% of partners' capital of the Partnership.

The accompanying notes are an integral part of the consolidated financial statements.

# Prospect Harbor Credit Partners, L.P.

## Consolidated Statement of Cash Flows

For the year ended December 31, 2009

<b>Cash used for operating activities:</b>	
Purchases of investments	\$ (1,712,395,684)
Payments for credit default swaps	(50,426,332)
Purchases of covers on securities sold short	(2,596,059)
Proceeds from credit default swaps	52,423,184
Proceeds from sales and maturities of investments	1,312,035,690
Proceeds from sales of securities sold short	11,610,000
Proceeds from principal paydowns of investments	186,133,727
Settlements of swap transactions	(282,430,384)
	<u>(485,645,858)</u>
<b>Increase in cash due to reconsolidation</b>	225,261,336
<b>Net effects from foreign currency translation</b>	(6,349,901)
<b>Net investment income</b>	62,106,776
<b>Adjustments to reconcile net investment income to net cash provided by operating activities:</b>	
Non-cash interest income	(14,346,697)
Amortization of upfront fees	35,334,238
Decrease in restricted cash for total return swaps	613,616,569
Decrease in restricted cash for credit default swaps	79,779,053
Increase in restricted cash for securities sold short	(8,647,561)
Increase in restricted cash	(10,000,000)
Increase in interest receivable	(1,341,634)
Decrease in related party receivable	6,660,810
Increase in other assets	(36,808)
Increase in management fee payable	549,000
Increase in interest payable	3,021,059
Decrease in accrued expenses and other liabilities	(530,791)
<b>Net cash provided by operating activities</b>	<u>499,429,591</u>
<b>Cash used for financing activities:</b>	
Payments of Senior Facility	(23,512,317)
Payment of Notes Payable	(40,306,830)
Decrease in due to broker - margin	(10,730,019)
Partners' capital withdrawals	(3,876,765)
<b>Net cash used for financing activities</b>	<u>(78,425,931)</u>
<b>Net increase in cash and cash equivalents</b>	421,003,660
<b>Cash and cash equivalents, beginning of year</b>	<u>174,686,375</u>
<b>Cash and cash equivalents, end of year</b>	<u>\$ 595,690,035</u>
<b>Supplemental disclosure of cash flow information:</b>	
Cash paid for interest	\$ 5,620,284
Taxes paid	\$ 16,530

The accompanying notes are an integral part of the consolidated financial statements.

**Prospect Harbor Credit Partners, L.P.**  
**Condensed Consolidated Schedule of Investments**  
**December 31, 2009**

<b>Investments 128.5%*</b>	<b>Fair Value</b>
<b>Corporate Fixed Income 45.8%*</b>	
Aerospace and Defense	\$ 18,769,100
Air Transportation	21,765,150
Automotive	39,921,367
Beverage and Tobacco	15,245,300
Broadcast Radio and Television	6,654,174
Building and Development	17,233,116
Business Equipment and Services	48,105,275
Cable Television	25,920,719
Chemical/Plastics	22,542,775
Conglomerates	18,444,060
Containers and Glass Products	53,315,716
Electronic/Electric	38,445,332
Equipment Leasing	13,447,525
Farming/Agriculture	4,255,000
Financial Intermediaries	10,799,581
Food Services	13,206,000
Food/Drug Retailers	8,255,080
Forest Products	13,632,000
Healthcare	26,698,750
Hotels/Motel/Inns and Casinos	29,212,600
Insurance	26,601,380
Leisure	10,366,400
Nonferrous Metals/Minerals	35,778,605
Oil and Gas	47,785,375
Publishing	5,539,166
Retailers (other than food/drug)	11,125,724
Steel	13,487,500
Telecommunications/Cellular communications	47,198,225
Utilities	25,193,665
<b>Total Corporate Fixed Income (Cost \$645,153,667)</b>	<b>\$ 668,944,660</b>
<b>Senior Bank Debt 67.2%*</b>	
Aerospace and Defense	36,761,570
Air Transportation	6,591,726
Automotive	120,766,686
Broadcast Radio and Television	39,688,697
Building and Development	11,883,324

The accompanying notes are an integral part of the consolidated financial statements.

**Prospect Harbor Credit Partners, L.P.**  
**Condensed Consolidated Schedule of Investments**  
**December 31, 2009**

Investments (continued)	Fair Value
Senior Bank Debt (continued)	
Business Equipment and Services	\$ 19,961,273
Cable Television	87,117,624
Chemical/Plastics	44,712,703
Clothing/Textiles	14,614,322
Conglomerates	28,562,013
Containers and Glass Products	27,333,812
Drugs	15,033,289
Electronic/Electric	24,258,058
Equipment Leasing	4,168,893
Financial Intermediaries	74,998,699
Food Products	14,323,532
Food Services	12,893,451
Food/Drug Retailers	9,440,802
Healthcare	42,779,336
Home Furnishings	5,149,170
Hotels/Motel/Inns and Casinos	40,701,307
Industrial Equipment	9,311,164
Insurance	17,884,098
Leisure	36,138,233
Nonferrous Metals/Minerals	7,720,853
Oil and Gas	86,399,819
Publishing	59,481,658
Retailers (other than food/drug)	15,808,713
Telecommunications/Cellular communications	44,148,023
Utilities	21,961,880
<b>Total Senior Bank Debt (Cost \$993,165,598)</b>	<b>\$ 980,594,728</b>
Common Stock 5.8%*	
Air Transportation	4,277,200
Automotive	5,077,142
Building and Development	2,340,761
Business Equipment and Services	5,475,928
Electronic/Electric	4,961,404
Farming/Agriculture	957,000
Financial Intermediaries	14,789,983
Food Products	4,053,500

The accompanying notes are an integral part of the consolidated financial statements.



**Prospect Harbor Credit Partners, L.P.**  
**Condensed Consolidated Schedule of Investments**  
**December 31, 2009**

<b>Investments (continued)</b>	<b>Fair Value</b>
<b>Common Stock (continued)</b>	
Healthcare	\$ 467,517
Insurance	6,514,200
Oil and Gas	17,641,279
Publishing	1,071,856
Retailers (other than food/drug)	9,048,806
Steel	1,533,400
Utilities	6,100,375
<b>Total Common Stock (Cost \$94,454,062)</b>	<b>\$ 84,310,351</b>
<b>Structured Investments 4.2%*</b>	
Structured Finance Obligation	61,368,330
<b>Total Structured Investments (Cost \$106,735,585)</b>	<b>\$ 61,368,330</b>
<b>Mezzanine 4.6%*</b>	
Automotive	3,008,680
Building and Development	6,497,348
Business Equipment and Services	1,326
Containers and Glass Products	968,799
Electronic/Electric	90,948
Farming/Agriculture	11,077,991
Financial Intermediaries	6,616,868
Food Services	13,369,273
Healthcare	11,682,121
Publishing	824,466
Retailers (other than food/drug)	2,340,263
Steel	11,136,779
<b>Total Mezzanine (Cost \$87,227,525)</b>	<b>\$ 67,614,862</b>
<b>Preferred Stock 0.3%*</b>	
Business Equipment and Services	43,105
Electronic/Electric	3,074,009
Healthcare	343,427
Retailers (other than food/drug)	401,455
<b>Total Preferred Stock (Cost \$4,663,327)</b>	<b>\$ 3,861,996</b>

The accompanying notes are an integral part of the consolidated financial statements.



**Prospect Harbor Credit Partners, L.P.**  
**Condensed Consolidated Schedule of Investments**  
**December 31, 2009**

Investments (continued)	Fair Value
Purchased Swaptions 0.6%*	
Financial Intermediaries	\$ 8,677,027
Total Purchased Swaptions (Cost \$10,350,000)	<u>\$ 8,677,027</u>
Warrants 0.0%*	
Broadcast Radio and Television	2,332
Business Equipment and Services	136,318
Farming/Agriculture	82,000
Total Warrants (Cost \$4,617,200)	<u>220,650</u>
Total Investments (Cost \$1,946,366,964)	<u>\$ 1,875,592,604</u>
Credit Default Swaps -1.4%*	
Providing Protection -1.6%*(a)	
Automotive	(63,377)
Chemical/Plastics	88,415
Containers and Glass Products	(121,997)
Equipment Leasing	(338,252)
Food/Drug Retailers	(59,981)
Retailers (other than food/drug)	14,528
Structured Finance Obligation	<u>(23,142,698)</u>
Total Providing Protection (Proceeds \$1,243,823)	<u>\$ (23,623,362)</u>
Receiving Protection 0.2%*	
Containers and Glass Products	92,163
Containers and Glass Products	334,118
Financial Intermediaries	52,469
Food Services	2,134,688
Structured Finance Obligation	69,222
Telecommunications/Cellular communications	<u>360,000</u>
Total Receiving Protection (Cost \$9,660,390)	<u>3,042,660</u>
Total Credit Default Swaps (Proceeds \$8,416,567)	<u>\$ (20,580,702)</u>
Securities Sold Short -0.8%*	
Corporate Fixed Income-0.8%	
Telecommunications/Cellular communications	<u>\$ (12,119,999)</u>
Total Corporate Fixed Income (Proceeds \$11,610,000)	<u>(12,119,999)</u>
Total Securities Sold Short (Proceeds \$11,610,000)	<u>\$ (12,119,999)</u>

The accompanying notes are an integral part of the consolidated financial statements.

**Prospect Harbor Credit Partners, L.P.**  
**Condensed Consolidated Schedule of Investments**  
**December 31, 2009**

Investments (continued)	Fair Value
Forward Contracts 0.2%*	
British Pound/USD	\$ (76,536)
Canadian Dollar/USD	178,912
Euro/USD	<u>2,294,410</u>
Total Forward Contracts (Cost \$0)	<u>\$ 2,396,786</u>
Interest Rate Swaps 0.0%*	<u>(221,201)</u>
Total Interest Rate Swaps (Cost \$0)	<u>\$ (221,201)</u>
Total Return Swaps -0.2%*	
Prospect Funding V, LLC	<u>(2,876,063)</u>
Total Return Swaps (Cost \$0)	<u>\$ (2,876,063)</u>

The geographical categorization by country of issuer of the value of investments is as follows:

USA	84.7%
Netherlands	3.8%
Germany	3.5%
United Kingdom	2.4%
Other	<u>5.6%</u>
	<u>100.0%</u>

At December 31, 2009, the country of issuer of the credit default swaps were as follows:

USA	100.1%
France	<u>-0.1%</u>
	<u>100.0%</u>

At December 31, 2009, the issuers of all securities sold short were from the United States

\*All investment category percentages are calculated as a percentage of total partners' capital of \$1,459,855,874.

(a) Credit Default Swaps for which the Partnership is providing protection have a total notional value of \$131,187,000.

The accompanying notes are an integral part of the consolidated financial statements.

**Prospect Harbor Credit Partners, L.P.**  
**Notes to Consolidated Financial Statements**  
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**1. Organization**

Prospect Harbor Credit Partners, L.P. (the "Partnership") is a Delaware limited partnership which commenced operations on March 3, 2004. The Partnership has established three wholly owned subsidiaries, Prospect Funding I, LLC ("Prospect Funding I" or the "Company") Prospect Funding III, LLC ("Prospect Funding III"), and Prospect Funding V, LLC ("Prospect Funding V") (collectively, the "Subsidiaries"). The consolidated financial statements of the Partnership reflect the operations of the Partnership as well as the Subsidiaries. Sankaty Advisors, LLC, a Delaware limited liability company and the credit and fixed income affiliate of Bain Capital, LLC, serves as investment advisor to the Partnership and the Subsidiaries (the "Investment Advisor"). Prospect Harbor Investors, LLC, a Delaware limited liability company and an affiliate of the Investment Advisor, serves as the General Partner of the Partnership (the "General Partner").

The investment objective of the Partnership is to provide superior risk-adjusted returns to the limited partnership interests by opportunistically investing in bank loans, high yield debt, credit default swaps and special situations. The Partnership's gross aggregate contributed capital is \$2.932 billion as of December 31, 2009. At December 31, 2009, the General Partner and other affiliated entities held 3.1% and 10.4%, respectively, of the aggregate contributed capital of all partners.

Prospect Funding I has \$1.1 billion of debt financing commitments under the 2006-1 Indenture Supplement dated July 3, 2006 and the 2007-1 Indenture Supplement dated July 31, 2007. \$904 million of debt financing commitments were outstanding as of December 31, 2009 (see Notes 9 - 13). The debt financing commitments subject the Company to certain covenants, including, but not limited to, limitations on the total amount of indebtedness of the Company, certain restrictions on payments, and requirements concerning compliance with certain financial test and investment policies.

Bank of New York Mellon Trust Company and Brown Brothers Harriman serves as the Partnership's custodian for senior bank debt securities. JP Morgan and Goldman Sachs and Co. act as prime brokers for the Partnership's corporate fixed income, public equity securities and certain senior bank debt securities under prime brokerage agreements.

In addition to direct commitments, Prospect Harbor Credit Partners (Offshore), L.P. and Prospect Harbor Credit Partners (Offshore Plan Assets), L.P. were established to acquire interests in the Partnership. At December 31, 2009, Prospect Harbor Credit Partners (Offshore), L.P. and Prospect Harbor Credit Partners (Offshore Plan Assets), L.P. comprised 48.9% and 6.7% of partners' capital, respectively.

In October 2008, the General Partner determined, that in the best interests of the Partnership, it would suspend Limited Partners' right to withdraw all or any portion of their Book Capital Accounts until the credit markets stabilized and liquidity returned to those markets. The Partnership deferred the cash payment of half of the advisory fees until the General Partner reinstated the right of withdrawal. As of December 31, 2009, the Partnership has reinstated the right to withdraw a certain portion of their Book Capital Accounts (see Note 14). As such the Investment Advisor has collected the deferred advisory fee payments.

**2. Significant Accounting Policies**

These consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"), which requires management to make estimates and assumptions that affect the reported amounts and disclosures in the consolidated financial statements. Actual results could differ from those estimates, and such differences could be material. Events or transactions occurring after period end through the date that the financial statements were issued, March 16, 2010, have been evaluated in the preparation of the financial statements.

**Principles of Consolidation**

The financial position (including all investment positions) and the results of operations relating to the Subsidiaries have been consolidated in the Partnership's consolidated financial statements. Transactions between the Partnership and the Subsidiaries have been eliminated.

From the inception of the Partnership to October 30, 2008 (the "Deconsolidation Date"), the Partnership



**Prospect Harbor Credit Partners, L.P.**  
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held a controlling interest and consolidated its investment in Prospect Funding I. As of October 30, 2008 Prospect Funding I defaulted on its debt covenants and the debt holders were allowed to accelerate payment of the debt. As a result of the default, the Partnership no longer maintained the ability to effect control over Prospect Funding I, and therefore did not consolidate the financial position or the results of operations for the period from the Deconsolidation Date to the Reconsolidation Date. On July 15, 2009 ("Reconsolidation Date"), Prospect Funding I cured all events of default and the Partnership gained the ability to effect control of Prospect Funding I. On the Reconsolidation Date, the Partnership commenced consolidation of Prospect Funding I's investments. For the period from the Deconsolidation Date to the Reconsolidation Date, the Partnership's investment in Prospect Funding I was accounted for at fair value, as determined by the General Partner. At the Reconsolidation Date, the Partnership's investment in Prospect Funding I was fair valued at \$216,704,325. Subsequent to the Reconsolidation Date, \$69,014,233, (\$9,823,756), (\$125,292,979), and \$295,057,580 of investment income, expenses, realized losses and unrealized gains, respectively are included in the Consolidated Statement of Operations. As a result of the default, the Partnership entered into a credit protection fee letter agreement with the issuer of credit protection on a portion of the debt issued by Prospect Funding I. During the year ended December 31, 2009, the Partnership incurred credit protection fee expenses of \$12,343,828 which is included in credit protection fee on the Consolidated Statement of Operations. As of December 31, 2009, the Partnership had a payable of \$5,848,206 for these fees which is included in accrued expenses and other liabilities on the Consolidated Statement of Assets, Liabilities and Partners' Capital.

**Valuation of Investments and Securities Sold Short**

The Investment Advisor, in consultation with the General Partner, fair values the investments owned by the Partnership. Corporate fixed income securities are generally valued based on the "high bid average" price obtained from an independent pricing service. Senior bank debt securities are generally valued based on the "mean of mean" price obtained from a loan pricing service. Public equities are generally valued based on the closing price listed on a United States securities exchange or, if unavailable, at the last bid price for long positions and last ask price for short positions. Swap contracts and other derivatives are fair valued as noted below. For additional information related to derivative instruments utilized, please see the following Notes: 3, 4, 5, 6, 7 and 8.

Investments that cannot be fair valued, as described above, (primarily mezzanine investments, structured investments and special situations) are valued at fair value as determined in good faith by the General Partner. In determining the fair value of an investment, the General Partner considers such factors as financial statements, earnings forecasts, recent transactions in the same or similar securities and valuation information obtained from broker-dealers, recognized quotation services or independent appraisal firms. The fair value assigned to these investments is based upon available information and does not necessarily represent the amount that might ultimately be realized upon sale. Equity investments in structured financing vehicles (such as CLOs) are fair valued by the General Partner using a model that utilizes inputs determined by the General Partner to discount present value of future cash flows from the investment. The General Partner determines the fair value of certain securities, including certain structured investments, held by the Partnership on the basis of prices provided by principal market makers. Due to the inherent uncertainty of valuation, this estimated fair value may differ from the value that would have been used had a ready market for the security existed, and the difference could be material.

**Cash and Cash Equivalents**

Cash and cash equivalents includes cash held at retail banks, custodial banks and prime brokers. Included in cash and cash equivalents at December 31, 2009 is \$567,798,835 invested overnight in six highly liquid money market investment vehicles bearing interest from 0.01% to 0.08%. Included in cash and cash equivalents at December 31, 2009 is \$394,740 invested overnight in a Cayman deposit account bearing interest of 0.03%. Cash balances are presented gross of amounts due to retail banks, custodial banks, and prime brokers.

**Due to Broker - margin**

Due to broker - margin represents short term margin debt balances held at various brokers.

**Restricted cash**

Restricted cash for total return swaps and collateral held for credit default swaps represents cash collateral



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maintained in accounts by the respective swap agreement counterparties (see Notes 6 and 7). Restricted cash for securities sold short represents funds maintained in interest bearing cash accounts with the custodian(s) or broker(s). Such funds are restricted from withdrawal to the extent of the value of the outstanding short sales shown on the Consolidated Statement of Assets, Liabilities and Partners' Capital.

**Investment Transactions, Investment Income and Expenses**

Investment transactions are accounted for on the trade date. Realized gains and losses on investment transactions are determined using the specific identification method. Interest income is recorded on the accrual basis. Expenses are on accrual basis. Premiums and discounts on securities purchased and securities sold short are amortized using the effective yield method over the life of the respective security when cash collection is expected and included in interest income (long investments) and interest expense (short investments). Discounts on securities with fair value below 50% of par are not amortized. Certain fees received or paid on bank loans are recorded as a cost basis adjustment or as income. Dividend income is recorded on the ex-dividend date net of withholding tax. Distributions from collateralized debt obligations are recorded as dividend income on the Consolidated Statement of Operations during the collateralized debt obligation's reinvestment period. Subsequent to this reinvestment period, distributions are recorded as a return of capital. Dividend and interest income paid in the form of additional shares or par value is recorded at current value. For the Partnership's investments in revolving bank loans, the cost basis of the investments purchased is adjusted for the cash received for the discount on the total balance committed. The fair value is also adjusted for price appreciation or depreciation on the unfunded portion. As a result, the purchase of commitments not completely funded may result in a negative value until it is offset by the future amounts called and funded.

In some cases, the Partnership invests in securities indirectly through one or more holding companies or other entities in which other parties affiliated with the Partnership and/or the Investment Advisor may also be investors. In cases where the Partnership invests directly through such an entity, the Condensed Consolidated Schedule of Investments reflects the Partnership's proportionate share of the underlying investment.

**Restricted Securities**

The Partnership is permitted to invest in securities that are subject to legal or contractual restrictions on resale. These securities generally may be resold in transactions exempt from registration or to the public if the securities are registered. Disposal of these securities may involve time consuming negotiations and expense, and prompt sale at an acceptable price may be difficult. At December 31, 2009, the fair value of restricted securities (excluding 144A issues) amounted to \$127,599,781.

**Income Taxes**

As a partnership, the Partnership itself is not subject to U.S. Federal income taxes. Each Partner is individually liable for income taxes, if any, on its share of the Partnership's net taxable income. Interest, dividends and other income realized by the Partnership from non-US sources and capital gains realized on the sale of securities of non-U.S. issuers may be subject to withholdings and other taxes levied by the jurisdiction in which the income is sourced. As of December 31, 2009, \$434,716 was the estimated payable relating to deferred taxes and is included in Accrued expenses and other liabilities on the Consolidated Statement of Assets, Liabilities and Partners' Capital.

For foreign partners invested in the Partnership, a reduction in capital could be made for withholding taxes (30% or lower treaty rate) on their allocable share of dividends as well as certain interest and other income received by the Partnership from sources within the United States.

On January 1, 2009, the Partnership adopted an accounting standard which required the Investment Advisor to determine whether tax positions of the Partnership are more likely than not to be sustained upon examination by the applicable taxing authority, including resolution of any related appeals or litigation processes, based on the technical merits of the position. For tax positions meeting the more likely than not threshold, the tax amount recognized in the financial statements is reduced by the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement with the relevant taxing authority. The Investment Advisor has determined that there were no tax positions which met the



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recognition and measurement requirements of the accounting standard, and therefore, the Partnership did not record an expense related to uncertain positions on the Partnership's Consolidated Statement of Operations for the year-ended December 31, 2009.

The Partnership files tax returns as prescribed by the tax laws of the jurisdictions in which it operates. In the normal course of business, the Partnership is subject to examination by federal, state, local and foreign jurisdictions, where applicable. As of December 31, 2009, the tax years that remain subject to examination by the major tax jurisdictions under the statute of limitations is from the year 2004 forward (with limited exceptions).

**Securities Sold Short**

Upon selling a security short, the Partnership recognizes the proceeds received as restricted cash in its Consolidated Statement of Assets, Liabilities and Partners' Capital and securities sold short is established as an offsetting liability. The cash is retained by the Partnership's prime brokers as collateral for the short position. The liability is fair valued while the position remains open to reflect the current settlement obligation and the amount of collateral is adjusted accordingly. When a closing purchase is entered into by the Partnership offsetting the security sold short, a gain or loss is realized based on the difference between the proceeds originally received and purchase cost.

A short sale creates a risk of a theoretically unlimited loss, in that the price of the underlying security could theoretically increase without limit thus increasing the cost to the Partnership of buying those securities necessary to cover a short position. There can be no assurance that the security necessary to cover a short position will be available for purchase. Purchasing securities to close out the short position can itself cause the price of the securities to rise further, thereby exacerbating the loss. As a result, short sales create risk that the Partnership's ultimate obligation to satisfy the delivery requirements may exceed the amount of the proceeds initially received or the liability recorded in the Consolidated Statement of Assets and Liabilities and Partners' Capital.

**Foreign Currency Translation**

The accounting records of the Partnership are maintained in U.S. dollars. The fair values of foreign securities, currency holdings and other assets and liabilities are translated to U.S. dollars based on the current exchange rates each business day. Income and expenses denominated in foreign currencies are translated at current exchange rates when accrued or incurred. Unrealized gains and losses on foreign currency holdings and non-investment assets and liabilities attributable to the change in exchange rates are included in foreign currency translation in the Consolidated Statement of Operations. Net realized gains and losses on foreign currency holdings and non-investment assets and liabilities are included in net realized gain on foreign currency transactions in the Consolidated Statement of Operations.

The portion of both realized and unrealized gains and losses on investments, credit default swaps and securities sold short that result from fluctuations in foreign currency exchange rates is not separately disclosed, but is included in net realized and unrealized gains on investments and securities sold short, and swap contracts in the Consolidated Statement of Operations.

**Forward Currency Contracts**

The Partnership enters into forward currency contracts in connection with settling planned purchases or sales of securities or to hedge the currency exposure associated with the Partnership's investments. A forward currency contract is an agreement between two parties to buy and sell a currency at a set price on a future date. Forward currency contracts are fair valued daily using a third party valuation service and the change in value is recorded as an unrealized gain or loss. Forward currency contracts are valued at the prevailing exchange rate of the underlying currencies. Realized gains and losses equal to the difference between the value of the contract at the time it was opened and the value at the time it was closed are recorded upon delivery or receipt of the currency or, if a forward currency contract is offset by entering into another forward currency contract with the same broker, upon settlement of the net gain or loss. During the year ended December 31, 2009, the Partnership recognized net realized losses of \$5,774,738, which are included in net realized loss on foreign currency transactions in the Consolidated Statement of Operations.



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These contracts may involve market risk in excess of the unrealized gain or loss reflected in the Partnership's Consolidated Statement of Assets, Liabilities and Partners' Capital. The Partnership may be exposed to risk if the counterparties are unable to meet the terms of the contract or if there are movements in foreign currency values that are unfavorable to the Partnership.

Unrealized gains and losses relating to the Partnership's forward currency contracts are recorded on the Consolidated Statement of Assets, Liabilities and Partner's Capital by type on a net basis. On the Condensed Consolidated Schedule of Investments, derivative contracts are presented net by type of derivative contract, considering long and short contracts separately.

**Options**

The Partnership buys call options and put options. The Partnership pays a premium for purchased options which is included in Cost of Investments on the Consolidated Statement of Assets, Liabilities and Partners' Capital. Premiums paid for purchased options which expire are treated as realized losses. Premiums paid for purchased options which are exercised or closed are offset against the proceeds from that transaction and included in realized gain or loss. Option contracts are fair valued daily using a third party valuation service and the change in value is recorded as unrealized appreciation or depreciation on investments in the Consolidated Statements of Operations.

The Partnership enters into swaption contracts which grants the purchaser the right, but not the obligation, to enter into an interest rate swap at a preset rate within a specified period of time. The purchaser pays a premium to the swaption writer who bears the risk of unfavorable changes in the preset rate on the underlying interest rate swap. Swaptions are fair valued using a third party valuation service. Purchased swaptions are included in Investments on the Consolidated Statement of Assets, Liabilities and Partners' Capital. The net change in unrealized appreciation or depreciation on investments is reported in the Consolidated Statement of Operations.

Written swaptions are reported as a liability in the Consolidated Statement of Assets, Liabilities, and Partners' Capital. The difference between the premium received or paid, and market value of the swaption, is recorded as unrealized appreciation or depreciation on written options. The net change in unrealized appreciation or depreciation is reported in the Consolidated Statement of Operations. When a swaption is exercised, the cost of the swap is adjusted by the amount of premium paid or received.

Upon the expiration or closing of an unexercised swaption contract, a gain or loss is reported in the Consolidated Statement of Operations for the amount of the premium paid or received. Swaption contracts written by the Partnership do not give rise to counterparty credit risk as they obligate the Partnership, not its counterparty, to perform.

The Partnership generally will incur a greater risk when it writes a swaption than when it purchases a swaption. When the Partnership purchases a swaption it risks losing only the amount of the premium they have paid if the option expires unexercised. When the Partnership writes a swaption it will become obligated, upon exercise of the option, according to the terms of the underlying agreement.

Unrealized gains and losses relating to the Partnership's derivative contracts are recorded on the Consolidated Statement of Assets, Liabilities and Partner's Capital on a gross basis. On the Condensed Consolidated Schedule of Investments, derivative contracts are presented net by type of derivative contract, considering long and short contracts separately.

**Credit Default Swaps**

The Partnership uses credit default swaps to provide a measure of protection against defaults of corporate issuers (i.e., to reduce risk where the Partnership owns or has exposure to the issuer) or to take an active long or short position with respect to the likelihood of a particular issuer's default. The reference obligation of the swap can be a single issuer, a "basket" of issuers, or an index. The underlying reference assets are corporate debt or loans. Under the terms of each transaction, the Partnership receives or makes payments quarterly based on a specified interest rate on a fixed notional amount. Net interest earned on swaps and



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realized gains or losses from closing out transactions is included in net realized loss on swap contracts in the Consolidated Statement of Operations.

Generally, a credit event for corporate reference obligations means bankruptcy, failure to pay, obligation acceleration, repudiation/moratorium or restructuring. If a credit event occurs, the seller typically must pay the contingent payment to the buyer, which is typically the par value of the reference obligation, though the actual payment may be mitigated by netting arrangements and collateral. After a credit event occurs, this amount may be reduced by anticipated recovery rates, segregated collateral and netting arrangements that may incorporate multiple transactions with a given counterparty. The contingent payment may be a cash settlement or a physical delivery of the reference obligation in return for payment of the face amount of the obligation. The Partnership closes out transactions by entering into offsetting transactions. When transactions are closed out, a realized gain or loss is recognized. In connection with these agreements, cash or securities are posted as collateral with the counterparty which is included in Restricted cash for credit default swaps on the Consolidated Statement of Assets, Liabilities and Partners' Capital.

The Partnership values credit default swaps based on quotes obtained from a third party pricing service. When a fair value is unavailable, as described above, fair values are determined in good faith by the General Partner. Entering into these agreements involves, to varying degrees, elements of credit, legal, market, and documentation risk in excess of the amounts recognized on the Consolidated Statement of Assets, Liabilities and Partners' Capital. Such risks involve the possibility that there will be no liquid market for these agreements and that the counterparty to the agreements may default on its obligation to perform or disagree as to the meaning of the contractual terms in the agreements.

The Partnership from time to time enters into various managed tranche credit default swap transactions ("Swap Transactions") whereby the Partnership contributes a net amount to financial intermediaries and provides protection, in aggregate, on pools of underlying reference assets. The net amount contributed consists of a gross amount paid upfront by the Partnership for potential credit events and a gross amount of upfront interest received by the Partnership for certain tranches of these pools. As of December 31, 2009, the Partnership holds thirteen Swap Transactions on seven pools of credit default swaps, of various credit quality, with a notional amount of \$85,415,884.

Upfront amounts received or paid are recorded as credit default swap proceeds or cost and accreted over the life of the respective credit default swaps and included in net realized loss on swap contracts in the Consolidated Statement of Operations.

Unrealized gains and losses relating to the Partnership's derivative contracts are recorded on the Consolidated Statement of Assets, Liabilities and Partner's Capital on a gross basis. On the Condensed Consolidated Schedule of Investments, derivative contracts are presented net by type of derivative contract, considering long and short contracts separately.

As of December 31, 2009, the Partnership is the buyer ("receiving protection") on credit default swaps on a total notional amount of \$311.1 million and is the seller ("providing protection") on credit default swaps on a total notional amount of \$131.2 million. The notional amounts of the swaps are not recorded in the financial statements; however, the notional amount does approximate the maximum potential amount of future payments that the Partnership could be required to make if the Partnership were the seller of protection and a credit event were to occur.

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Those credit default swaps for which the Partnership is providing protection at December 31, 2009 are summarized as follows:

Written Credit Derivative Contracts	Single Name Credit Default Swap (in thousands)		Credit Default Swap Basket (in thousands)		Total
	Debt	Loan	Debt	Loan	
Fair value of written credit derivatives	\$ (7,732)	\$ -	\$ -	\$ (15,891)	\$ (23,623)
Maximum potential amount of future payments	45,771	-	-	85,416	131,187
Collateral held by the Partnership or other third parties which the Partnership can obtain upon occurrence of triggering event	16,145	-	-	16,428	32,573

Maximum Potential Amount of Future Payments by Contract Term (in thousands)						
Current credit rating on underlying securities	0-6 months	6-12 months	1-5 years	5-10 years	More than 10 years	Total
Investment Grade	\$ -	\$ -	\$ -	\$ -	\$ 13,510	\$ 13,510
Non-Investment Grade	1,750	-	27,931	-	2,580	32,261
Swap Transactions	-	8,802	76,614	-	-	85,416
Total	\$ 1,750	\$ 8,802	\$ 104,545	\$ -	\$ 16,090	\$ 131,187

The credit rating disclosed above for each reference obligation where the Partnership is the seller of protection is a representation of the current payment/performance risk of the swap. Reference obligations with a credit rating of BBB or higher are considered Investment Grade while those with a credit rating of BB or lower are Non-Investment Grade. Swap Transactions are not rated by ratings agencies; however, the current credit ratings on the underlying pools of credit default swaps are predominately non-investment grade.

In some cases, the Partnership has purchased related credit protection with respect to the underlying securities where it has previously sold credit protection, thereby limiting its exposure. In these instances, the extent of recourse is difficult to estimate and therefore not disclosed.

**Interest Rate Swaps and Total Return Swaps**

The Partnership enters into interest rate or total return swap contracts to increase or decrease its exposure to changes in the level of interest rates or underlying asset values. Interest rate swaps involve the exchange by the Partnership with another party of their respective commitments to pay or receive interest at specified intervals based on a notional amount of principal, e.g. an exchange of floating rate payments for fixed payments with respect to a notional amount of principal. Total return swaps involve commitments to pay interest in exchange for a return on a basket of securities both based on notional amounts. To the extent the total return of the basket of securities underlying the transaction exceeds or falls short of the offsetting interest rate obligation, the Partnership will receive payment from or make a payment to the counterparty, respectively. The Partnership values total returns swaps based on the unrealized gains or losses on the basket of securities underlying the transactions. The assets underlying the transaction are valued in accordance with the Partnership's valuation policy for loans noted above.



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**3. Recent Accounting Pronouncements**

**FASB Accounting Standards Codification™ ASC 105-10**

In June 2009, the FASB issued FASB ASC 105-10, *The FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles*, (formerly SFAS 168). FASB ASC 105-10 replaces the SFAS 162, *The Hierarchy of Generally Accepted Accounting Principles*, and establishes the FASB Accounting Standards Codification ("Codification") as the source of authoritative accounting principles recognized by the FASB to be applied by non-governmental entities in the preparation of financial statements in conformity with GAAP. The Codification became the exclusive authoritative reference at September 30, 2009. Updates to the Codification Standards are issued as Accounting Standard Updates ("ASU"s) by the FASB. The adoption of the Codification does not impact the Partnership's financial statements except for references made to authoritative accounting literature in the footnotes.

**FASB Accounting Standards Codification™ ASC 815-10-50**

The Partnership adopted amendments to authoritative guidance on disclosures about derivative instruments and hedging activities on January 1, 2009. The new requirement amends and expands the disclosure requirement related to derivative instruments, to provide users of financial statements with an enhanced understanding of the use of derivative instruments by the Partnership and how these derivatives affect the financial position, financial performance and cash flows of the Partnership. This statement requires qualitative disclosures about the objectives and strategies for using derivative instruments, quantitative disclosures about the fair value of, and gains and losses on, derivative instruments.

The standard enhances the disclosure requirements for derivative instruments and related hedging activities and thus, the adoption of the standard had no impact on the Consolidated Statement of Assets, Liabilities and Partners' Capital, Consolidated Statement of Operations or the Consolidated Statement of Changes in Partners' Capital. The Partnership does not designate any derivative instruments as hedging instruments under the authoritative guidance.

The Partnership transacts in a variety of derivative instruments including, forwards, swaps and options primarily for trading purposes with each instrument's primary risk exposure being interest rate, credit, foreign exchange or equity risk. The fair value of these derivative instruments is included either as a separate line item, or in the case of purchased options within the Investments line item, in the Consolidated Statement of Assets, Liabilities and Partners' Capital with changes in fair value reflected as realized gains (losses) or net change in unrealized gains (losses) on investments and swap contracts within the Consolidated Statement of Operations.



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The following table lists fair value of derivatives by contract type as included in the Consolidated Statement of Assets, Liabilities and Partners' Capital:

The total notional or contractual amounts and fair values for derivatives were:			
(Dollars in thousands)	Notional/contractual amount	Gross Derivative Assets (at fair value)	Gross Derivative Liabilities (at fair value)
Interest Rate Contracts	\$ 50,000	\$ -	\$ (221)
Total Return Swaps (Debt)	67,417	-	(2,876)
Forward Currency Contracts	(172,109)	3,292	(895)
Credit Default Swaps	(179,901)	3,183	(23,764)
Purchased Swaptions	300,000	8,677	-
Total		\$ 15,152	\$ (27,756)
Netting (see note below) *		(895)	895
Carrying value of derivatives on the Consolidated Statements of Assets, Liabilities and Partners' Capital		\$ 14,257	\$ (26,861)

\*Note: GAAP permits the netting of derivative assets and liabilities and the related cash collateral received and paid when a legally enforceable master netting agreement exists between the Partnership and a derivative counterparty.

During the year ended December 31, 2009, the average notional exposure on interest rate contracts, total return swaps, forward currency contracts, credit default swaps, and purchased swaptions was \$81,250,000, \$390,350,142, (\$83,197,240), \$52,232,547 and \$300,000,000 respectively.

The following table indicates the gains and losses on derivatives, by contract type, as included in the Consolidated Statement of Operations for the year ended December 31, 2009:

The gains (losses) recognized in the consolidated statement of operations related to derivatives were:	
(Dollars in thousands)	For the year ended December 31, 2009
Interest Rate Contracts	\$ (311)
Total Return Swaps (Debt)	151,662
Forward Currency Contracts	(6,858)
Credit Default Swaps	(23,130)
Purchased Swaptions	(1,673)
Total	\$ 119,690

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The above gains (losses) on derivatives have been recognized as realized/ change in unrealized on the Consolidated Statement of Operations.

The significant accounting policies relating to recording of derivatives and related gain/(loss) have been summarized in Note 2 of the financial statements.

By using derivative instruments, the Partnership is exposed to the counterparty's credit risk - the risk that derivative counterparties may not perform in accordance with the contractual provisions offset by the value of any collateral received. The Partnership's exposure to credit risk associated with counterparty non-performance is limited to collateral posted and the unrealized gains inherent in such transactions that are recognized in the Consolidated Statement of Assets, Liabilities and Partners' Capital. The Partnership minimizes counterparty credit risk through, credit monitoring procedures, executing master netting arrangements and managing margin and collateral requirements, as appropriate. The Partnership records counterparty credit risk valuation adjustments, if material, on certain derivative assets in order to appropriately reflect the credit quality of the counterparty.

**4. Fair Value Measurements**

In accordance with authoritative guidance on fair value measurements and disclosures under GAAP, the Partnership discloses the fair value of its investments in a hierarchy which prioritizes and ranks the level of market price observability used in measuring assets or liabilities at fair value. Market price observability is affected by a number of factors, including the type of investment and the characteristics specific to the investment. Assets or liabilities with readily available active quoted prices or for which fair value can be measured from actively quoted prices generally will have a higher degree of market price observability and a lesser degree of judgment used in measuring fair value.

Inputs are used in applying the various valuation techniques and broadly refer to the assumptions that market participants use to make valuation decisions, including assumptions about risk. Inputs may include price information, volatility statistics, specific and broad credit data, liquidity statistics, and other factors. In such cases, the determination of which category within the fair value hierarchy is appropriate for any given investment is based on the lowest level of input that is significant to the fair value measurement. The Partnership's assessment of the significance of particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the investment. The General Partner considers observable data to be that market data which is readily available, regularly distributed or updated, reliable and verifiable, not proprietary, and provided by independent sources that are actively involved in the relevant market. The categorization of a financial instrument within the hierarchy is based upon the pricing transparency of the instrument and does not necessarily correspond to the General Partner's perceived risk of that instrument.

In determining an asset or liability's placement within the hierarchy, the General Partner separates the Partnership's investment portfolio into two major categories as determined by the General Partner. Each of these categories can further be divided between those held long or short.

Assets or liabilities measured and reported at fair value are classified and disclosed in one of the following categories:

Level I – Quoted prices are available in active markets for identical assets or liabilities as of the reporting date. The type of assets or liabilities included in Level I include listed equities.

Level II – Inputs are other than quoted prices that are observable for the assets or liabilities either directly or indirectly, including inputs in markets that are considered to be active. Certain investments, exchange traded and over-the-counter derivatives, including forwards, credit default swaps, and interest rate swaps, are valued by the General Partner using observable inputs, such as quotations received from pricing services, dealers or brokers, whenever available and considered reliable. In instances where models are used, the value of an over-the-counter derivative depends upon the contractual terms of, and specific risks



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inherent in, the instrument as well as the availability and reliability of observable inputs. Such inputs include market prices for reference securities, bid and ask prices yield curves, credit curves, measures of volatility, prepayment rates and correlations of such inputs. Certain exchange traded and over-the-counter derivatives, such as generic forwards, swaps and options, have inputs which can generally be corroborated by market data and are therefore classified within Level II. Assets or liabilities which are generally included in this category include corporate bonds and loans where there is sufficient market activity for the investment, options, less liquid and restricted equity securities and certain exchange traded and over-the-counter derivatives.

Level III – Investments and derivative instruments classified within Level III have significant unobservable inputs, as they trade infrequently or not at all. Level III instruments include private equity investments, certain bank loans and bridge loans, less liquid corporate debt securities (including distressed debt and mezzanine instruments), structured products (including CLOs and MBS), total return swaps, and credit default swaps. When observable prices are not available for these securities, the General Partner uses one or more valuation techniques (e.g., the market approach or the income approach) for which sufficient and reliable data is available. Within Level III, the use of the market approach generally consists of using comparable market transactions, while the use of the income approach generally consists of the net present value of estimated future cash flows, adjusted as appropriate for liquidity, credit, market and/or other risk factors.

The inputs used by the General Partner in estimating the value of Level III investments include the original transaction price, recent transactions in the same or similar instruments, completed or pending third-party transactions in the underlying investment or comparable issuers, subsequent rounds of financing, recapitalizations and other transactions across the capital structure, offerings in the equity or debt capital markets, and changes in financial ratios or cash flows. Certain Level III investments, such as structured investments, utilized models which rely on assumptions by the General Partner. Level III investments may also be adjusted to reflect illiquidity and/or non-transferability, with the amount of such discount estimated by the General Partner in the absence of market information. The fair value measurement of Level III investments does not include transaction costs that may have been capitalized as part of the security's cost basis. Assumptions used by the General Partner due to the lack of observable inputs may significantly impact the resulting fair value and therefore the Partnership's results of operations. Those over-the-counter derivatives that have less liquidity or for which inputs are unobservable are classified within Level III. While the valuations of these less liquid over-the-counter derivatives may utilize some Level I and/or Level II inputs, they also include other unobservable inputs which are considered significant to the fair value determination. At each measurement date, the General Partner updates the Level I and Level II inputs to reflect observable inputs, though the resulting gains and losses are reflected within Level III due to the significance of the unobservable inputs.

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The following table summarizes the valuation of the Partnership's assets or liabilities by the above fair value hierarchy levels as of December 31, 2009:

Assets at Fair Value as of December 31, 2009 (in thousands)	Level I	Level II	Level III	Total
Cash Equivalents	\$ 567,799	\$ -	\$ -	\$ 567,799
Investments:				
Corporate Fixed Income	-	664,209	4,735	668,944
Senior Bank Debt	-	891,472	89,123	980,595
Mezzanine	-	-	67,615	67,615
Preferred Stock	-	-	3,862	3,862
Common Stock	31,602	-	52,708	84,310
Purchased Swaptions	-	8,677	-	8,677
Structured Investments	-	-	61,368	61,368
Stock Warrants	-	-	221	221
Credit Default Swaps (Assets)	-	688	2,495	3,183
Forward Contracts (Assets)	-	2,397	-	2,397
Subtotal	\$ 599,401	\$ 1,567,443	\$ 282,127	\$ 2,448,971
Liabilities at Fair Value as of December 31, 2009 (in thousands)	Level I	Level II	Level III	Total
Securities Sold Short:				
Corporate Fixed Income	-	(12,120)	-	(12,120)
Credit Default Swaps (Liabilities)	-	(620)	(23,143)	(23,763)
Interest Rate Swap Contracts (Liabilities)	-	(221)	-	(221)
Total Return Swaps (Liabilities)	-	-	(2,876)	(2,876)
Subtotal	\$ -	\$ (12,961)	\$ (26,019)	\$ (38,980)
Total	\$ 599,401	\$ 1,554,482	\$ 256,108	\$ 2,409,991

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The following table presents changes in assets or liabilities that use Level III inputs for the period ended December 31, 2009:

(in thousands)	Balance as of 12/31/2008	Net change unrealized gains (losses)	Net realized gains (losses)	Net purchases, sales, or redemptions	Net transfers into and/or (out of) Level III	Balance as of 12/31/09
Investments:						
Corporate Fixed Income	\$ 4,913	\$ 8,938	\$ (28)	\$ 417	\$ (9,505)	\$ 4,735
Senior Bank Debt	9,028	46,631	(21,758)	59,327	(4,105)	89,123
Mezzanine	39,398	11,920	(19,713)	36,010	-	67,615
Preferred Stock	4,474	(320)	127	(419)	-	3,862
Structured Investments	220,146	233,862	64,983	(457,623)	-	61,368
Stock Warrants	174	(4,488)	-	4,535	-	221
Common Stock	34,393	29,232	(41,243)	30,326	-	52,708
Total Return Swaps (Liabilities)	(343,469)	340,593	(190,603)	190,603	-	(2,876)
Credit Default Swaps (Assets)	-	(7,390)	233	9,292	360	2,495
Credit Default Swaps (Liabilities)	(45,453)	20,690	(21,981)	23,601	-	(23,143)
Total	<u>\$ (76,396)</u>	<u>\$ 679,668</u>	<u>\$ (229,983)</u>	<u>\$ (103,931)</u>	<u>\$ (13,250)</u>	<u>\$ 256,108</u>

All net realized and unrealized gains (losses) in the table above are reflected in the accompanying Statement of Operations. During the year ended December 31, 2009, the change in unrealized appreciation on investments classified as Level III at December 31, 2009 was \$23,681,474. See Note 2 for the Partnership's valuation techniques used to measure fair value.

Effective January 1, 2009, the Partnership adopted the authoritative guidance under GAAP on determining fair value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly. Accordingly, if the Partnership determines that either the volume and/or level of activity for an asset or liability has significantly decreased (from normal conditions for that asset or liability) or price quotations or observable inputs are not associated with orderly transactions, increased analysis and management judgment will be required to estimate fair value.



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Valuation techniques such as an income approach might be appropriate to supplement or replace a market approach in those circumstances. The guidance also provides a list of factors to determine whether there has been a significant decrease in relation to normal market activity. Regardless, however, of the valuation technique and inputs used, the objective for the fair value measurement in those circumstances is unchanged from what it would be if markets were operating at normal activity levels and/or transactions were orderly; that is, to determine the current exit price.

The Partnership has also adopted the authoritative guidance under GAAP for estimating the fair value of investments in investment companies that have calculated net asset value per share in accordance with the specialized accounting guidance for Investment Companies. Accordingly, in circumstances in which net asset value per share of an investment is not determinative of fair value, the Partnership estimates the fair value of an investment in an investment company using the net asset value per share of the investment (or its equivalent) without further adjustment, if the net asset value per share of the investment is determined in accordance with the specialized accounting guidance for Investment Companies as of the reporting entity's measurement date. The adoption of this guidance does not have a material effect on the financial statements.

There have been no significant changes in valuation techniques and related inputs used by the General Partner during the year ended December 31, 2009.

**5. Market and Credit Risks of Debt Securities**

The Partnership's investing activities expose it to various types of risk that are associated with the financial instruments and markets in which it invests. The significant types of financial risks to which the Partnership is exposed to are listed below.

**Market Risk**

Market risk encompasses the potential for both losses and gains and includes price risk, currency risk and interest rate risk. The fair value of investments and securities sold short will generally fluctuate with, among other things, changes in prevailing interest rates, general economic conditions, the condition of certain financial markets, developments or trends in any particular industry and the financial condition of the issuer. During periods of limited liquidity and higher price volatility, the Partnership's ability to dispose of investments at a price and time that the Partnership deems advantageous may be impaired.

**Price Risk**

The prices of securities held by the Partnership may decline in response to certain events, including those directly involving the companies whose securities are owned by the Partnership; conditions affecting the general economy; overall market changes; local, regional or global political, social or economic instability; and currency, interest rate and commodity price fluctuations.

**Currency Risk / Foreign Markets Risks**

The Partnership may invest in financial instruments and enter into transactions denominated in currencies other than its functional currency. Consequently, the Partnership may be exposed to risks that the exchange rate of its currency relative to other foreign currencies may change in a manner that has an adverse effect on the fair value of that portion of the Partnership's assets or liabilities denominated in currencies other than the functional currency.

The Partnership may have investments in various countries, including emerging market countries. Investments in these countries involve risks, including, but not limited to, risks relating to adverse political, social, and economic developments in other countries, as well as risks resulting from the differences between the regulations to which issuers and markets are subject in different countries. These risks may include expropriation of assets, confiscatory taxation, withholding taxes on dividends and interest paid on Partnership investments, currency exchange controls, and other limitations on the use or transfer of Partnership assets and political or social instability. Such investments may also involve currency exchange rate risks. There may be rapid changes in the value of foreign currencies or securities, causing the fair value of Partnership investments to be volatile.



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**Interest Rate Risk**

Interest rate risk refers to the risks associated with market changes in interest rates. Interest rate changes may affect the value of a debt instrument indirectly and directly. In general, rising interest rates will negatively impact the price of a fixed rate debt instrument and falling interest rates will have a positive effect on price. Adjustable rate instruments also react to interest rate changes in a similar manner although generally to a lesser degree. Interest rate sensitivity is generally more pronounced and less predictable in instruments with uncertain payment or prepayment schedules.

The interest rate hedging transactions subject the Partnership to off balance-sheet risks, which include counterparty credit risk. The Partnership manages this exposure by entering into interest rate hedging transactions with internationally recognized financial institutions, which are expected to perform under the terms of the contracts, and evaluating the creditworthiness of the institutions by taking into account credit ratings and other factors.

**Liquidity Risk**

Liquidity risk is the risk that the Partnership will encounter difficulty in meeting obligations associated with financial liabilities. Among other things liquidity could be impaired by an inability to access secured and/or unsecured sources of financing.

**Leverage Risk**

The Partnership uses leverage directly and indirectly. The Partnership currently uses leverage mainly through the Wholly Owned Financing Subsidiaries and total return swaps. The use of leverage will increase the volatility of the Partnership. While the use of borrowed funds will increase returns if the Partnership earns a greater return on the incremental investments purchased with borrowed funds than it pays for such funds, the use of leverage will decrease returns if the Partnership fails to earn as much on such incremental investments as it pays for such funds. The effect of leverage may therefore result in a greater decrease in the net asset value of the Partnership than if the Partnership was not as leveraged.

**Financing Risk**

In the normal course of business, the Partnership enters into agreements with certain counterparties for OTC derivative transactions. These agreements contain, among other conditions, events of default and termination events, and various covenants and representations. At certain times during 2009, the Company was not in compliance with certain covenants in the agreements. If such events are not cured by the Company or waived by the counterparties, the counterparties may decide to curtail or limit extension of credit, and the Company may be forced to unwind its derivative positions which may result in material losses. For the year ended December 31, 2009, interest rate swaps were terminated as a result of non-compliance with covenants. As of December 31, 2009, the Company had no outstanding derivative contracts.

There is no guarantee that the Partnership's borrowing arrangements or other arrangements for obtaining leverage will continue to be available, or if available, will be available on terms and conditions acceptable to the Partnership. Unfavorable economic conditions also could increase funding costs, limit access to the capital markets or result in a decision by lenders not to extend credit to the Partnership. In addition, a decline in market value of the Partnership's assets may have particular adverse consequences in instances where they have borrowed money based on the market value of those assets. A decrease in market value of those assets may result in the lender (including derivative counterparties) requiring the Partnership to post additional collateral or otherwise sell assets at a time when it may not be in the Partnership's best interest to do so.

**Illiquidity of Investments**

The Partnership may invest in securities, bank debt and other claims, and other assets, which are subject to legal or other restrictions on transfer or for which no liquid market exists. The market prices, if any, for such investments tend to be volatile and may not be readily ascertainable, and, for various reasons, the Partnership may not be able to sell them when it desires to do so or to realize what it perceives to be their fair value in the event of a sale. Restricted securities are generally valued at a price lower than similar



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securities that are not subject to restrictions on resale.

Some of the Partnership's investments may be illiquid and the Partnership may not be able to vary the portfolio in response to changes in economic and other conditions. The securities that are purchased in connection with privately negotiated transactions are not registered under the relevant securities laws, which may result in a prohibition against their transfer, sale, pledge or other disposition except in a transaction that is exempt from the relevant registration requirements. Some of the bank loans, mezzanine securities and structured investments that are purchased and sold are traded in private, unregistered transactions and are therefore may be subject to restrictions on resale or otherwise have no established trading market. In addition, if the Partnership is required to liquidate all or a portion of its portfolio quickly, the Partnership may realize significantly less than the value at which it previously recorded those investments. The Partnership may from time to time invest in derivative contracts traded over the counter, which are not traded in an organized public market and may be illiquid. Furthermore, the Partnership may face other restrictions in its ability to liquidate an investment in a business entity to the extent that the Partnership have or could be attributed with material non-public information regarding such business entity.

**Credit Risk**

Credit risk refers to the likelihood that an issuer will default in the payment of principal and/or interest on an instrument. Financial strength and solvency of an issuer are the primary factors influencing credit risk. In addition, subordination, lack or inadequacy of collateral or credit enhancement for a debt instrument may affect its credit risk. Credit risk may change over the life of an instrument and securities which are rated by rating agencies are often reviewed and may be subject to downgrade.

The Partnership is subject to the credit risk of its custodians, prime brokers and counterparties to the extent they may be unable to fulfill their obligations either to return the Partnership's securities or to repay amounts owed. Credit risk is measured by the loss the Partnership would record if its counterparties failed pursuant to terms of their obligations to the Partnership.

**Bank Loans**

The Partnership invests in loans originated by banks and other financial institutions. The loans invested in by the Partnership may include term loans and revolving loans, may pay interest at a fixed or floating rate and may be senior or subordinated and may be purchased in the form of assignments or participations in all or a portion of loans from third parties. Purchasers of bank loans are predominantly commercial banks, investment funds and investment banks. Based on activity in the bank loan market, the Partnership is exposed to liquidity risk as well as the risk of the borrower.

**High Yield Debt**

The Partnership invests in high yield debt whose rating is typically below investment-grade by one or more nationally recognized statistical rating organizations or is unrated but of comparable credit quality to obligations rated below investment-grade, and has greater credit and liquidity risk than more highly rated debt obligations. As a result, the Partnership is exposed to liquidity risk and the risk of the obligor.

**Credit Derivatives**

The Partnership invests in credit derivatives. These transactions generally provide for the transfer from one counterparty to another of certain credit risks inherent in the ownership of a financial asset such as a bank loan or a high yield debt security. Such risks include, among other things, the risk of default and insolvency of the obligor of such asset, the risk that the credit of the obligor or the underlying collateral will decline or that credit spreads for like assets will change. Credit derivatives are used to gain or reduce exposure to one or more reference assets, to reduce concentration risk, or to diversify the investment portfolio.

**Structured Investments**

The Partnership invests in structured investments. The structured investments include investments in both collateralized debt obligations and collateralized loan obligations and are either debt or subordinated equity investments. These investments have limited secondary markets and in some instances can have restrictions



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on transfers. Debt investments are nonrecourse obligations; therefore, the debt is payable solely from the collateral obligations and all other assets pledged. Depending on the structure of the investment and the investment made, the Partnership's debt investments could be subordinate to other classes of debt. All equity interests are unsecured and subordinate to all classes of debt. Subordinated debt and equity investments represent leveraged investments in underlying assets.

**Mortgage-Backed Securities**

The Partnership invests in mortgage-backed securities through collateralized mortgage obligations. Mortgage-backed securities represent direct or indirect participations in, or are collateralized by and payable from, mortgage loans secured by residential real property. The value of these securities may also fluctuate in response to the market's perception of the credit worthiness of the underlying mortgage loans and the adequacy of the collateral which secures the underlying mortgage loan. The Partnership's investments in these mortgage-backed securities are reflected in the accompanying Condensed Consolidated Schedule of Investments within the structured investments classification.

**Options**

The Partnership has purchased put options. Purchasing put options will generally decrease the Partnership's exposure to the underlying instrument. The Partnership's risk is limited to the premium paid.

**6. Wholly Owned Financing Subsidiaries**

**Prospect Funding I, LLC ("Prospect Funding I")**

Prospect Funding I commenced operations on March 3, 2004 and is a Delaware limited liability company whose sole member is the Partnership. On July 9, 2004, the Partnership and Prospect Member I, Inc. (the initial "Independent Manager") entered into an amended and restated limited liability company agreement. Prospect Funding I, was established for the purpose of acquiring and managing a diverse portfolio of primarily below investment-grade assets consisting of bank loans, bank loan participations, high yield securities (including convertible bonds), mezzanine investments, preferred stock, public and private equity securities, and certain other investments. Subject to certain limited instances in which the consent of the Independent Manager is required, the Partnership manages the business affairs of Prospect Funding I and may remove or appoint an Independent Manager, provided that the Rating Agency Condition is satisfied and a replacement Independent Manager satisfying certain specified criteria is appointed as further described in the Prospect Funding I, Master Indenture and Indenture Supplement both dated as of July 9, 2004 (the "Original Indenture").

Prospect Funding I has \$1.1 billion of debt financing commitments under the 2006-1 Indenture Supplement dated July 3, 2006 and the 2007-1 Indenture Supplement dated July 31, 2007. As of December 31, 2009, \$904 million of debt financing commitments were outstanding (see Notes 9-13).

Though Prospect Funding I's assets and liabilities are presented as part of the Partnership's consolidated financial statements, Prospect Funding I represents a separate and distinct entity from the Partnership. Creditors of the Partnership are entitled to look solely to the assets of the Partnership (which includes the Partnership's equity interest in Prospect Funding I) to satisfy any liabilities of the Partnership.

**Prospect Funding III, LLC ("Prospect Funding III")**

Prospect Funding III commenced operations on July 1, 2004 and is a Delaware limited liability company whose sole member is the Partnership. Prospect Funding III entered into a Master Swap Agreement (the "Prospect Funding III Swap Agreement") with Wachovia Bank for purposes of executing a bank loan and high yield securities total return swap. The assets in the swap were selected by Prospect Funding III and agreed to by Wachovia Bank. Upon the addition of each asset to the notional amount of the swap contract, Prospect Funding III provided Wachovia Bank with collateral equal to a fixed percent of the purchase price of the underlying asset. Each month, collateral requirements are re-assessed based on the addition or removal of assets from the notional amount. Any excess collateral was returned to Prospect Funding III and



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recorded as return of collateral; any shortfall of collateral was paid by Prospect Funding III to Wachovia Bank and recorded as a contribution of collateral. Prospect Funding III Swap Agreement was terminated on July 1, 2009.

The Prospect Funding III Swap Agreement provided for Prospect Funding III to pay interest to Wachovia Bank on the outstanding notional amount of the swap contract and to receive interest payments and fees on the underlying assets. In addition, any net gains due to sales or paydowns were paid by Wachovia Bank to Prospect Funding III. If there was a net loss, Prospect Funding III paid the amount of this loss to Wachovia Bank. All payments of net interest and net gain or loss were netted and distributed monthly, and are included in the net realized loss on swap contracts in the Consolidated Statement of Operations. During the year ended December 31, 2009, Prospect Funding III recognized net realized losses of \$60,091,037, which are included in the net realized loss on swap contracts in the Consolidated Statement of Operations.

**Prospect Funding V, LLC ("Prospect Funding V")**

Prospect Funding V commenced operations on December 19, 2006 and is a Delaware limited liability company whose sole member is the Partnership. Prospect Funding V entered into a Master Swap Agreement (the "Prospect Funding V Swap Agreement") with Barclays for purposes of executing a bank loan and high yield securities total return swap. The assets in the swap are selected by Prospect Funding V and agreed to by Barclays. Upon the addition of each asset to the notional amount of the swap contract, Prospect Funding V must provide Barclays with collateral equal to a fixed percent of the purchase price of the underlying asset. Each month, collateral requirements are re-assessed based on the addition or removal of assets from the notional amount and the fair value of the underlying assets. Any excess collateral is returned to Prospect Funding V and recorded as return of collateral; any shortfall of collateral is paid by Prospect Funding V to Barclays and recorded as a contribution of collateral. At December 31, 2009, \$45,431,335 of collateral had been posted, which is included in restricted cash for total return swaps in the Consolidated Statement of Assets, Liabilities and Partners' Capital. The scheduled termination date of the Prospect Funding V Swap Agreement is April 4, 2010.

The Prospect Funding V Swap Agreement provides for Prospect Funding V to pay interest to Barclays on the outstanding notional amount of the swap contract and to receive interest payments and fees on the underlying assets. In addition, any net gains due to sales or paydowns are paid by Barclays to Prospect Funding V. If there is a net loss, Prospect Funding V pays the amount of this loss to Barclays. All payments of net interest and net gain or loss are netted together and distributed monthly, and are included in the net realized loss on swap contracts in the Consolidated Statement of Operations. During the year ended December 31, 2009, Prospect Funding V recognized net realized losses of \$47,114,173. Net interest and net gain or loss earned, but not yet paid by Prospect Funding V are included in the realized loss on swap contracts in the Consolidated Statement of Operations. During the year ended December 31, 2009, \$26,615,332 of realized losses are included in the Consolidated Statement of Operations for net interest and net gain or loss earned, but not yet paid.

At December 31, 2009, the total notional amount of the swap was approximately \$67.4 million.

**7. Total Return Swap**

**Prospect Harbor Deutsche Bank TRS ("PRO DB")**

The Partnership entered into a Master Swap Agreement with Deutsche Bank for the purpose of executing a bank loan total return swap on May 15, 2007. Each underlying bank loan in the swap was selected by the Partnership and agreed to by Deutsche Bank. Upon the addition of each bank loan to the notional amount of the swap contract, the Partnership provided Deutsche Bank with collateral equal to a percent of the purchase price of the underlying bank loan. Each month, collateral requirements are re-assessed based on the addition or removal of assets from the notional amount. Any excess collateral was returned to the Partnership as return of collateral; any shortfall of collateral was paid by the partnership to Deutsche Bank and recorded as a contribution of collateral. The Swap Agreement was terminated on June 5, 2009.

The swap agreement provided for the Partnership to pay interest to Deutsche Bank on the outstanding notional amount of the swap contract and to receive interest payments and fees on the underlying assets. In



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addition, any net gains due to sales or paydowns were paid by Deutsche Bank to the Partnership. If there was a net loss, the Partnership pays the amount of this loss to Deutsche Bank. All payments of net interest and net gain or loss were netted and distributed monthly, and are included in the net realized gain on swap contracts in the Consolidated Statement of Operations. During the year ended December 31, 2009, the Partnership recognized net realized losses of \$89,477,313, which are included in net realized loss on swap contracts in the Consolidated Statement of Operations.

**8. Interest Rate Hedging Transactions**

The Partnership and the Subsidiaries enter into interest rate hedging transactions to partially bridge their fixed and floating rate assets and liabilities, reducing their interest rate exposure. The Partnership does not hold these instruments for trading purposes.

During the year ended December 31, 2009, Prospect Funding I terminated all outstanding interest rate swap contracts. For the year ended December 31, 2009, Prospect Funding I incurred net interest expenses of \$867,531, which is included in net realized loss on swap contracts on the Consolidated Statement of Operations and made net cash payments of \$1,027,328 under the terms of the interest rate swap contracts. Prospect Funding I recorded a realized loss of \$4,919,440 on the termination of the swap contracts, which is included in net realized loss on swap contracts.

As of December 31, 2009, Prospect Funding III held two interest rate swap contract with a total notional amount of \$50.0 million and various termination dates between January 27, 2010 and March 3, 2010. The interest rate swap contracts reset quarterly and require Prospect Funding III to pay fixed rates between 4.134% and 4.430% and receive 3-month LIBOR. Prospect Funding III paid no premiums to enter into the interest rate swap contracts. For the year ended December 31, 2009, Prospect Funding III incurred net interest expense of \$1,671,562, which is included in net realized loss on swap contracts, and paid cash of \$1,458,693 under the terms of the interest rate swap contracts. As of December 31, 2009, the fair value of the interest rate swap contracts was (\$221,201).

The interest rate hedging transactions subject the Partnership and the Subsidiaries to off balance-sheet risks, which include counterparty credit risk. The Partnership and the Subsidiaries manage this exposure by entering into interest rate hedging transactions with internationally recognized financial institutions, which are expected to perform under the terms of the contracts, and by evaluating the creditworthiness of the institutions by taking into account credit ratings and other factors.

**9. 2006 Variable Funding Notes (VFN)**

The Company and various financial institutions entered into a VFN Purchase Agreement dated July 3, 2006 with an aggregate line of credit of \$230 million (the "2006-1 VFN"). The 2006-1 VFN includes Base Rate, Multi-currency, and Cost of Funds loans and a Swingline facility. A commitment fee of 0.23% is payable for any unused portion of the total commitment. The scheduled termination date of the 2006-1 VFN is July 1, 2013. On February 26, 2009, there was a total commitment reduction for \$30 million on the Swingline facility leaving the Company with an aggregate line of credit of \$200 million. During the year ended December 31, 2009, there were two payments made by the company to certain financial institutions in connection with the default of certain covenants of the Note Payable Indenture for \$35,986,325 and \$8,865,071. As of December 31, 2009, the Company had borrowed \$100,359,196 under the 2006-1 VFN, which is included as Senior Facility on the Consolidated Statement of Assets, Liabilities and Partners' Capital.

Cost of Funds loans can be drawn with three day's notice and bear interest equal to the Commercial Paper Note rate (as defined in the Senior Facility) per annum. As of December 31, 2009, the Company had no Cost of Funds loans outstanding.

Dollar LIBOR loans and Multi-Currency LIBOR loans can be drawn with three day's notice and bear interest equal to LIBOR (as defined in the VFN Purchase Agreement). Multi-currency loans can be



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denominated in Pounds Sterling, Swiss Francs, Swedish Kronor or Euros. As of December 31, 2009, the Company had \$13,435,609 of Dollar LIBOR loans outstanding. This balance included one loan with a principal balance of \$13,435,609, an interest rate of 0.58% and a maturity date of January 25, 2010.

As of December 31, 2009, the Company had \$86,923,587 of Multi-Currency LIBOR loans outstanding, which was denominated in Euro and GBP. This balance included three Euro loans with principal balances ranging from \$18,272,335 to \$39,429,777, interest rates ranging from 0.79% to 0.80%, and maturity dates ranging from January 21, 2010 to January 29, 2010. This balance also included one GBP loan with a principal balance of \$3,255,523, an interest rate of 0.86% and a maturity date of January 11, 2010.

Base Rate loans can be drawn with two day's notice and bear interest at the higher of the federal funds effective rate plus 0.5% per annum, or the prime rate. As of December 31, 2009, the Company had no Base Rate loans outstanding.

Interest incurred on the 2006-1 VFN for the year ended December 31, 2009 was \$1,624,419. Cash paid for interest on the 2006-1 VFN during the year ended December 31, 2009 was \$1,826,626.

**10. 2007 Variable Funding Notes**

The Company and various financial institutions entered into a VFN Purchase Agreement dated July 31, 2007 with a line of credit of \$240 million (the "2007-1 VFN"). The 2007-1 VFN includes Dollar LIBOR and Foreign Currency loans. A commitment fee of 0.23% is payable for any unused portion of the total commitment. The scheduled termination date of the 2007-1 VFN is July 1, 2014. During the year ended December 31, 2009, there were two payments made by the Company to certain financial institutions in connection with the default of certain covenants of the Note Payable Indenture for \$56,456,486 and \$13,126,048. As of December 31, 2009, the Company had \$142,417,465 of outstanding borrowings under the 2007 VFN, which is included as Senior Facility on the Consolidated Statement of Assets, Liabilities and Partners' Capital.

Dollar LIBOR loans can be drawn with three day's notice and bear interest equal to LIBOR (as defined in the Senior Facility). As of December 31, 2009, the Company had \$142,417,465 of Dollar LIBOR loans outstanding. This balance included one loan with a principal balance of \$142,417,465, interest rate of .60% maturity date of January 25, 2010.

Foreign Currency loans can be drawn with four day's notice and bear interest at a rate of interest determined by reference to the LIBOR Rate (as defined in the VFN Purchase Agreement). Foreign Currency loans can be denominated in Pounds Sterling, Canadian Dollars, Swiss Francs, Swedish Kronor or Euros. As of December 31, 2009, the Company had no Foreign Currency loans outstanding.

Interest incurred on the 2007-1 VFN for the year ended December 31, 2008 was \$1,387,469. Cash paid for interest on the 2007-1 VFN during the year ended December 31, 2009 was \$1,447,214.

**11. Senior Facility**

The Company and various financial institutions entered into a Senior Credit Agreement dated July 31, 2007 with a line of credit of \$35 million (the "Senior Facility"). The Senior Facility included Base Rate, Dollar Libor, and Foreign Currency loans and Dollar and Foreign Currency Swingline facilities. During the year ended December 31, 2009, there were two payments made by the Company to certain financial institutions for principal and commitment reductions made in connection with the default of certain covenants of the Note Payable Indenture for \$9,320,646 and \$2,167,036. The remaining Senior Credit Agreement was repaid in full and terminated on July 16, 2009. Interest incurred on the Senior Facility for the year ended December 31, 2009 was \$384,032. Cash paid for interest on the Senior Facility during the year ended December 31, 2009 was \$410,477.

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**12. 2006 Second Senior Credit Agreement**

The Company and various financial institutions entered into a Second Senior Credit Agreement dated July 3, 2006 (the "2006-1 Second Senior Credit Agreement") and \$45,000,000 was issued to the Company on July 3, 2006 and is included as Second Senior Facility on the Consolidated Statement of Assets, Liabilities and Partners' Capital. The scheduled termination date of the 2006-1 Second Senior Credit Agreement is July 1, 2013. The 2006-1 Second Senior Credit Agreement can be repaid, in whole or in part, at any time.

The 2006-1 Second Senior Credit Agreement bears interest at a rate of LIBOR plus 0.43% per annum. Interest under the 2006-1 Second Senior Credit Agreement will accrue and be payable quarterly on January 1, April 1, July 1 and October 1 of each calendar year.

Interest incurred on the 2006-1 Second Senior Credit Agreement for the year ended December 31, 2009 was \$609,667. Cash paid for interest on the 2006-1 Second Senior Credit Agreement during the year ended December 31, 2009 was \$120,491.

On July 15, 2009, the Partnership bought \$25,508,119 of the 2006 Second Senior Credit Agreement. This amount had not been repaid and was outstanding as of December 31, 2009.

**13. Notes Payable**

At December 31, 2009, pursuant to the 2006-1 Indenture Supplement and the 2007-1 Indenture Supplement, the Company had issued four classes of notes (collectively the "Notes"). During the year ended December 31, 2009, there were two payments made by the Company to certain financial institutions for principal and commitment reductions made in connection with the default of certain covenants of the Note Payable Indenture for \$194,402,052 and \$45,198,188. On July 15, 2009, the Partnership bought \$6,717,805 and \$33,589,025 of the Class A-6 and Class A-8 Notes, respectively, for par and accrued interest. On August 4, 2009, these Notes were withdrawn from the Depository Trust Company and were cancelled by the Trustee.

As of December 31, 2009, the Notes have varying tranches as follows:

Class	Title	Commitment and Outstanding		Interest Rate at December 31, 2009
		Principal (in millions)	Interest	
A-2	First Senior Secured Floating Rate Notes	\$ 137.7	LIBOR + 0.31%	0.5997%
A-6	First Senior Secured Fixed Rate Notes	\$ 201.5	Fixed	5.5660%
A-7	First Senior Secured Floating Rate Notes	\$ 94.1	LIBOR + 0.31%	0.5997%
A-8	First Senior Secured Floating Rate Notes	\$ 16.8	LIBOR + 0.28%	0.5697%
B-2	Second Senior Secured Floating Rate Notes	\$ 51.0	LIBOR + 0.50%	0.7897%
C-1	Mezzanine Secured Fixed Rate Notes	\$ 24.1	Fixed	6.4520%
C-2	Mezzanine Secured Floating Rate Notes	\$ 32.8	LIBOR + 0.90%	1.1897%
D-1	Junior Secured Fixed Rate Notes	\$ 18.6	Fixed	7.9520%
D-2	Junior Secured Floating Rate Notes	\$ 38.8	LIBOR + 2.40%	2.6897%
		<u>\$ 615.4</u>		

Interest is payable quarterly in January, April, July and October of each year for all of the Notes.

The A-2 Notes will mature on July 1, 2013, unless redeemed or repaid. The Company may redeem the A-2 Notes, without penalty, in whole or in part, after July 3, 2009. The A-6, A-8, B-2, C-1, C-2, D-1 and D-2 Notes will mature on July 1, 2014, unless redeemed or repaid. The A-7 Notes will mature on July 1, 2012,



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unless redeemed or repaid. The A-6, C-1 and D-1 Notes may not be optionally redeemed prior to their stated maturity. The A-7 and A-8 Notes may be redeemed, without penalty, in whole or in part, at the Issuers' option on any day on or after July 1, 2009. The B-2, C-2 and D-2 Notes can be redeemed, without penalty, in whole or in part, at the Issuers' option on any day on or after July 1, 2010.

The Class A Notes rank pari passu with all indebtedness designated as Senior Indebtedness pursuant to the Pledge and Intercreditor Agreement (the "Pledge and Intercreditor Agreement"), dated as of July 9, 2004. The Class B Notes rank pari passu with all indebtedness designated as Second Senior Indebtedness pursuant to the Pledge and Intercreditor Agreement (the "Pledge and Intercreditor Agreement"), dated as of July 9, 2004. The Class C Notes rank pari passu with all indebtedness designated as Mezzanine Indebtedness pursuant to the Pledge and Intercreditor Agreement (the "Pledge and Intercreditor Agreement"), dated as of July 9, 2004. The Class D Notes rank pari passu with all indebtedness designated as Junior Indebtedness pursuant to the Pledge and Intercreditor Agreement (the "Pledge and Intercreditor Agreement"), dated as of July 9, 2004.

During the year ended December 31, 2009, interest incurred on the Notes was \$21,885,415 and cash paid for interest on the Notes was \$23,254,092.

In accordance with authoritative guidance, the Company discloses the estimated fair values of certain of the Company's financial liabilities. At December 31, 2009, the Company estimated the fair value of the Class A-2, A-6, A-7, A-8, B-2, C-1, C-2, D-1 and D-2 Notes to be \$127.8 million, \$198.5 million, \$83.8 million, \$16.0 million, \$42.0 million, \$18.1 million, \$22.0 million, \$12.3 million and \$22.9 million, respectively. The fair value information presented above does not purport to represent, nor should it be construed to represent, the underlying "market" value of the Notes or the amount that would result from the sale, or settlement, of such Note. These estimates were based on a discounting of expected interest and principal distributions at the market rate of similar recently issued notes.

**14. Transactions with Affiliates**

**Management fees**

On the first business day of each fiscal quarter, the Partnership pays the Investment Advisor a management fee at the annual rate of 1.5% based on the Fee Basis Amount. The Fee Basis Amount is calculated for each limited partner at the beginning of each fiscal quarter as the sum of such limited partners' book capital account, any net unrealized gain/loss on Designated Investments (though the General Partner may elect to exclude this amount), and any carried interest allocated to the General Partner in respect of such limited partner during the current fiscal year.

The management fee will be paid at an annual rate of 1.25% for any portion of a limited partner's book capital account, which such limited partner agrees not to withdraw for a period of at least five years. The Investment Advisor may, in its sole discretion, waive the advisory fee with respect to certain members of the Sankaty Group and other Fee Waiver Partners. The amount of management fees waived for the year ended December 31, 2009 was \$2,555,949. As discussed in Note 1, the Partnership was required to defer cash payment of half of the advisory fees until the General Partner reinstated the right of withdrawal. On October 22, 2009, the right of withdrawal was reinstated and the deferred cash payments have been made to the Investment Advisor. As of December 31, 2009, \$200,625 is payable to the Investment Advisor and all management fees are included on the Consolidated Statement of Operations.

On January 1, 2005, the Partnership entered into an agreement with the Investment Advisor in respect of any managed Swap Transactions, whereby the Investment Advisor will furnish advice to the Partnership regarding the terms thereof and the composition of the reference portfolios of the Swap Transaction. On the first business day of each fiscal quarter, the Partnership pays the Investment Advisor a fee for advice on each Swap Transaction ("Swap Management Fee") in an amount equal to the product of the Notional Amount with respect to such Swap Transaction and an annual rate as noted below. The Partnership paid \$41,020 of Swap Management Fees to the Investment Advisor during the year ended December 31, 2009 which is included in professional fees and other operating expenses on the Consolidated Statement of



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Operations. As of December 31, 2009, the Partnership did not hold any tranches of managed Swap Transactions.

<b>Swap Transaction</b>	<b>Notional Amount</b>	<b>Tranche</b>	<b>Fee Percentage</b>
Plum Island I	\$5 million	10 – 13%	0.70%
Plum Island II	\$4.45 million	13 – 16%	0.65%

**Collateralized Debt Obligations (“CDOs”)**

The Partnership has invested in the following CDOs (both cash flow and market CDOs) managed by the Investment Advisor. The Partnership’s investment in these CDOs are reflected in the accompanying Condensed Consolidated Schedule of Investments within the Structured Investments classification.

**Chatham Light CLO, Ltd. (“Chatham Light”)**

The Partnership has invested in Chatham Light, a cash flow CDO, managed by the Investment Advisor. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds - and commenced operations in December 2004.

Chatham Light’s capital structure consists of \$139 million of various classes of debt and Income Notes. Income Notes are unsecured and subordinated with respect to the cash payments to all other debt holders. The Income Note holders do not control the election of the directors. During the year ended December 31, 2004, the Partnership purchased a \$5,250,000 face value of the Income Notes at par. As of December 31, 2009, the Partnership’s investment was fair valued at \$427,875. During the year ended December 31, 2009, the Partnership received income distributions of \$118,360 for its investment in Chatham Light which are included in dividends and other income in the accompanying Consolidated Statement of Operations. The CDO pays management fees to the Investment Advisor equal to 0.25% annually of the sum of total par of the CDO and eligible investments. The CDO may also pay subordinated management fees equal to 0.50% annually of the sum of total par of the CDO and eligible investments if certain criteria in the CDO are met.

**Chatham Light II CLO, Ltd. (“Chatham Light II”)**

The Partnership has invested in Chatham Light II, a cash flow CDO, managed by the Investment Advisor. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds - and commenced operations in August 2005.

Chatham Light’s capital structure consists of \$536 million of various classes of debt and Income Notes. Income Notes are unsecured and subordinated with respect to the cash payments to all other debt holders. The Income Note holders do not control the election of the directors. During the year ended December 31, 2005, the Partnership purchased an \$8,000,000 face value of the Income Notes at par. During the year ended December 31, 2009, the Partnership purchased a \$752,956 face value investment in the Class D notes for \$380,318, a \$10,000,000 face value investment in the Class A-2 notes for \$3,400,000, and a \$180,000 face value investment in the Class C notes for \$15,300. As of December 31, 2009, the Partnership’s investments were fair valued at \$451,774, \$7,500,000, \$108,000, and \$5,682,400 for the Class D Notes, Class A-2 Notes, Class C Notes and Income Notes, respectively. During the year ended December 31, 2009, the Partnership received income distributions of \$251,595 for its investment in Chatham Light II which are included in dividends and other income in the accompanying Consolidated Statement of Operations. The CDO pays management fees to the Investment Advisor equal to 0.25% annually of the sum of total par of the CDO and cash. The CDO may also pay subordinated management fees equal to 0.50% annually of the sum of total par of the CDO and cash if certain criteria in the CDO are met. The Partnership earned interest income of \$9,443, \$122,106, and \$2,811 for its investment in Class D Notes, Class A-2 Notes, and Class C Notes, respectively, which are included in interest income in the accompanying Consolidated Statement of Operations.

**Katonah IV CLO, Ltd. (“Katonah IV”)**

The Partnership has invested in Katonah IV, a cash flow CDO, managed by the Investment Advisor. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds - and commenced operations in February 2003.



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Katonah's capital structure consists of \$350 million of various classes of debt and Preference Shares. Preference Shares are unsecured and subordinated with respect to cash payments to all other debt holders. The Preference Share holders do not control the election of the directors. During the year ended December 31, 2006, the Partnership purchased a \$700,000 face value investment in the Preference Shares for \$581,000. As of December 31, 2009, the Partnership's investment was fair valued at \$189,980. During the year ended December 31, 2009, the Partnership received no distributions for its investment in Katonah IV. The CDO pays management fees to the Investment Advisor equal to 0.10% annually of the sum of total par of the CDO and cash. The CDO may also pay subordinated management fees equal to 0.40% annually of the sum of total par of the CDO and cash if certain criteria in the CDO are met.

**Avery Point CLO, Ltd. ("Avery Point")**

The Partnership has invested in Avery Point, a cash flow CDO, managed by the investment advisor. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds - and commenced operations in December 2003.

Avery Point's capital structure consists of \$510 million of various classes of debt and Preference Shares. Preference Shares are unsecured and subordinated with respect to cash payments to all other debt holders. The Preference Share holders do not control the election of the directors. During the year ended December 31, 2006, the Partnership purchased a \$3,130,000 face value investment in the Preference Shares for \$2,378,000. As of December 31, 2009, the Partnership's investment was fair valued at \$1,611,950. During the year ended December 31, 2009, the Partnership received income distributions of \$132,777 for its investment in Avery Point which are included in dividends and other income in the accompanying Consolidated Statement of Operations. The CDO pays management fees to the Investment Advisor equal to 0.10% annually of the aggregate capital balance. The CDO may also pay subordinated management fees equal to 0.50% annually of the aggregate collateral if certain criteria in the CDO are met.

**Race Point III CLO, Ltd. ("Race Point III")**

The Partnership has invested in Race Point III, a cash flow CDO, managed by the Investment Advisor. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds - and commenced operations in April 2006.

Race Point III's capital structure consists of \$610.7 million of various classes of debt and Income Notes. Income Notes are unsecured and subordinated with respect to the cash payments to all other debt holders. The Income Note holders do not control the election of the directors. During the year ended December 31, 2006, the Partnership purchased a \$13,360,000 face value investment in the Income Notes at par. During the year ended December 31, 2009, the Partnership purchased a \$300,000 face value investment of the Class D Notes for \$163,530. As of December 31, 2009, the Partnership's investments in Race Point III were fair valued at \$5,389,424 and \$174,000 for the Income Notes and Class D Notes, respectively. During the year ended December 31, 2009, the Partnership received income distributions of \$771,252 for its investment in Race Point III which are included in dividends and other income in the accompanying Consolidated Statement of Operations. The CDO pays management fees to the Investment Advisor equal to 0.20% annually of the sum of total par of the CDO and cash. The CDO may also pay subordinated management fees equal to 0.55% annually of the sum of total par of the CDO and cash if certain criteria in the CDO are met. During the year ended December 31, 2009, the Partnership earned interest income of \$1,419 for its investment in Class D Notes which is included in the interest income in the accompanying Consolidated Statement of Operations.

**Nash Point CLO, Ltd. ("Nash Point")**

The Partnership has invested in Nash Point, a cash flow CDO, managed by the Investment Advisor. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds - and commenced operations in July 2006.

Nash Point's capital structure consists of €600.0 million of various classes of debt and Income Notes. Income Notes are unsecured and subordinated with respect to the cash payments to all other debt holders. The Income Note holders do not control the election of the directors. During the year ended December 31,



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2007, the Partnership purchased a €14,650,000 face value investment in the Income Notes at par. During the year ended December 31, 2009, the Partnership purchased a €180,000 face value investment in the Class C Notes for €59,400. As of December 31, 2009, the Partnership's investments were fair valued at \$7,583,665 and \$148,168 for the Income Notes and Class C Notes, respectively. During the year ended December 31, 2009, the Partnership received income distributions of \$2,431,707 for its investment in Nash Point which are included in dividends and other income in the accompanying Consolidated Statement of Operations. The CDO pays management fees to the Investment Advisor equal to 0.25% annually of the sum of total par of the CDO and cash. The CDO may also pay subordinated management fees equal to 0.50% annually of the sum of total par of the CDO and cash if certain criteria in the CDO are met. During the year ended December 31, 2009, the Partnership earned interest income of \$1,614 for its investment in Class C Notes which is included in the Interest Income in the accompanying Consolidated Statement of Operations.

**Winter Harbor CLO, Ltd. ("Winter Harbor")**

The Partnership invested in Winter Harbor, a cash flow CLO, managed by the Investment Advisor. This entity was established for the purpose of making leveraged investments in high yield securities - both bank loans and corporate bonds through a total return swap - and commenced operations in October 2008.

Winter Harbor entered into a Master Swap Agreement with Bank of America, the Class A noteholder, for the purpose of executing a bank loan total return swap on October 24, 2008. Each underlying bank loan in the swap was selected by the Investment Advisor and agreed to by Bank of America. After an initial six month period, the portfolio remained static. The scheduled termination date is April 1, 2010.

Winter Harbor's capital structure consisted of \$1,050 million of Class A Notes and \$363 million of Subordinated Interest. Subordinated Interest is unsecured and subordinated with respect to cash payments to all other debt holders. During the year ended December 31, 2008, the Partnership purchased a \$203.0 million face value investment in the Subordinated Interest in Winter Harbor at par. During the years ended December 31, 2008 and 2009, the Partnership paid \$18,263,000 and \$3,096,800, respectively, in fees that are included in the cost basis of the investment.

The swap agreement provided for Winter Harbor to receive interest payments and the return on the underlying assets. Winter Harbor paid the proceeds of these amounts to Bank of America to make interest payments and to reduce the amount of debt outstanding. Once certain financing thresholds were met, distributions were made to both Winter Harbor and Bank of America in accordance with the terms of their Master Swap Agreement. During the year ended December 31, 2009, all of the debt in the capital structure was paid. During the year ended December 31, 2009, the swap agreement was terminated and Winter Harbor began a liquidation process to distribute all of its assets and the Partnership received \$294,510,368 of distributions. Gains of \$124,073,225 were realized and are included in Realized gains on the investments in the accompanying Consolidated Statement of Operations. As of December 31, 2009, \$53,922,658 is receivable by the Partnership and is included in Receivable for investments sold on the Consolidated Statement of Assets, Liabilities and Partners' Capital.

Winter Harbor was also required to comply with certain covenants to its swap agreement, which included an overcollateralization test, a collateral quality test and an event of default. The overcollateralization test required Winter Harbor to maintain collateral that exceeded a set percentage of the par amount of the debt. On any payment date on which the coverage tests were not satisfied, Winter Harbor was required to pay down the principal of the debt until these tests were satisfied. The collateral quality test sets criteria for rating, diversity and recovery of the underlying assets.

An event of default included the failure to pay the necessary interest or principal to the debt holders, bankruptcy of Winter Harbor, or if the ratio of the aggregate collateral principal to the outstanding debt was less than 105%. Upon an event of default, all proceeds had to be used to pay the interest and principal of the debtholders and if the event of default continues, the debtholders had the unilateral right to direct the liquidation of the assets.



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**Prospect Funding I**

The Partnership has invested in the Second Senior Credit Agreement of Prospect Funding I, a wholly owned financing subsidiary of the Partnership. During the year ended December 31, 2009, the Partnership purchased a face value investment of \$25,508,119 at par. This investment is eliminated in the consolidation.

**Bain Capital Investments**

Certain other investments included in the accompanying Condensed Consolidated Schedule of Investments have been issued by organizations in which investment funds advised by a related party have made substantial equity investments and may control many of these organizations. At December 31, 2009, the aggregate fair value of these securities was \$130,679,731

From time to time the Partnership may sell investments to other entities advised by the Investment Advisor. All such cross trades are executed at a price provided by a third party, where available. If no third party price is available, the Investment Advisor will purchase or sell the asset to a third party to determine a price or utilize another third party price source approved by the Investment Advisor compliance group. All such cross trades are reviewed by the Investment Advisor compliance group. During the year ended December 31, 2009, the Partnership sold investments, including interests in Swap Transactions at fair value, to other entities advised by the Investment Advisor or its affiliates for proceeds of \$219,650,575 resulting in a net realized loss of \$18,774,401. At December 31, 2009, the Partnership had \$38,582,064 included in Payable for investments purchased relating to investment transactions with other entities advised by the Investment Advisor. At December 31, 2009, the Partnership had \$9,580,589 included in Receivable for investments sold relating to investment transactions with other entities advised by the Investment Advisor.

**Other Expenses and Payables**

During the year ended December 31, 2009, \$2,272,064 of the Partnership's expenses were paid by a related party of the General Partner, which were reimbursed by the Partnership. All expenses paid by the related party were reimbursed during the year and there is no payable as of December 31, 2009.

**15. Commitments**

Certain of the Partnership's investments in revolving bank loans and bridge loans include unfunded commitments. As of December 31, 2009, unfunded commitments totaled \$24,912,943.

In the normal course of business, the Partnership and the Subsidiaries enter into contracts that contain a variety of representations and warranties and which provide general indemnifications. The Partnership's maximum exposure under these is unknown, as this would involve future claims that may be made against the Partnership that have not yet occurred. However, based on experience, the General Partner expects the risk of loss to be remote.

**16. Partners' Capital and Allocations**

The General Partner is required to maintain a Book Capital Account of at least 1% of the aggregate of all Partners.

No Limited Partner may withdraw any portion of its Book Capital Account attributable to a capital contribution until 24 months after the date of such capital contribution without the consent of the General Partner, and no partial withdrawal that is not a multiple of \$250,000, or that would reduce a Limited Partner's Book Capital Account below \$1,000,000 can be made without the consent of the General Partner. In no event shall a Limited Partner be permitted to withdraw any amount exceeding such Limited Partner's Basic Capital Account. Except as otherwise permitted by the General Partner, no Limited Partner or group of affiliated Limited Partners may withdraw amounts in excess of 2.5% of the aggregate Book Capital Accounts of all Partners, and the aggregate withdrawals made by all Partners in a particular fiscal period shall not exceed 10% of the aggregate Book Capital Accounts of all Partners. The General Partner may at its sole discretion at any time and for any reason require a limited partner to withdraw all or any portion of its Basic Capital Account. Notwithstanding the limitations described above, a Limited Partner may elect to



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make automatic annual withdrawals at the end of each fiscal year in an amount equal to the net income and realized profits allocated to such Limited Partner during that fiscal year, net of all expenses allocated to such Limited Partner during that fiscal year. The General Partner may suspend or limit all withdrawals, or defer payment of withdrawals, under certain circumstances set forth in the Partnership Agreement, including when the General Partner deems such action to be in the interests of the Partnership. A Limited Partner may withdraw from such Limited Partner's Book Capital Account only on the last business day of any fiscal quarter or on the first business day of any fiscal year and with at least 60 days written notice to the General Partner. In October 2008, the General Partner determined it would suspend Limited Partners' right to withdraw all or any portion of their Book Capital Accounts until the credit markets stabilize and liquidity returns to those markets (see Note 1). On October 22, 2009, the suspension was lifted and withdrawal rights as described were reinstated.

**Income, Expense, and Carried Interest Allocations**

As of the last business day of each fiscal period, realized and unrealized investment profits and losses of the Partnership from such period will initially be apportioned to the Partners in proportion to their respective Basic Capital Accounts as of the first business day of such fiscal period, subject to certain adjustments. New Issue Charge and New Issue Profit or Loss for such period will initially be apportioned to the New Issue Partners, and New Issue Credit will be apportioned to the non-New Issue Partners in proportion to their respective Basic Capital Accounts as of the first business day of such fiscal period, subject to certain adjustments. Designated Investment Profit or Loss for such fiscal period with respect to Designated Investments will initially be apportioned to the Partners in proportion to their respective proportionate share of such Designated Investments. Miscellaneous Income and Expense for such fiscal period will initially be apportioned to the Partners in proportion to their Book Capital Accounts as of the first business day of such fiscal period.

As of the last business day of each fiscal period in which net profit was initially apportioned to Limited Partners, such net profit then will be allocated between each Limited Partner and the General Partner as follows: first to such limited partner's Book Capital Account until such limited partner has been allocated a Total Return with respect to such fiscal year reflecting a 5% annualized rate of return on such Limited Partner's Hurdle Calculation Basis. Next, the Net Profit will be allocated to the General Partner's Book Capital Account as carried interest until the cumulative amount equals 20% of the net profits allocated to General Partner in respect of such Limited Partner and to such Limited Partner in the current fiscal year. Lastly, 80% and 20% of the net profit or loss will be allocated to such Limited Partner and to the General Partner, respectively. As of the last business day of each fiscal period in which net loss was initially apportioned to the Limited Partners, such net loss will then be allocated between each Limited Partner and the General Partner so as to reverse any net profits allocated as provided above during the relevant fiscal year.

In October 2008, the General Partner implemented a retroactive high water mark starting January 1, 2007 and running through December 31, 2010. Therefore, for current investments in the Partnership, the General Partner will not be allocated carried interest until a Limited Partner's Book Capital Account returns to the value as of January 1, 2007, or if the investment was made after such date, the value at investment.

The General Partner may waive all or any part of the carried interest that it would otherwise be entitled to receive from partners who are members of the Sankaty Group and other Carry Waiver Partners. There was no carried interest allocated or waived during the year ended December 31, 2009.

**New Issues**

Realized and unrealized profits and losses on certain securities involving initial public offerings are allocated only to those partners that are not considered restricted persons as defined by the Financial Industry Regulatory Authority, Inc. (FINRA). The restricted partners are allowed New Issue gains and losses at the same percentage as their beneficial ownership unless the combined beneficial ownership of these partners exceeds 10%, in which case only 10% of the New Issue gains and losses will be allocated. The remaining New Issue gains and losses are allocated to those partners who do participate in New Issues. The accounts of those partners who do not participate in New Issues are credited with interest on their proportionate share of the funds utilized to purchase New Issues. During the year ended December 31, 2009, there were no realized or unrealized profits from New Issues.



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**Profits and Losses of Designated Investments**

Profits and losses relating to certain illiquid securities designated as such by the General Partner ("Designated Investments") are allocated to Partners upon realization and as of the last day of each fiscal period in proportion to the partners' respective share of each Designated Investment. Partners' respective share of the Designated Investment is based on their Basic Capital Accounts as of the beginning of the fiscal quarter in which the Designated Investment was originally acquired or designated. There were no Designated Investments held as of December 31, 2009.

**17. Lehman Brothers Holdings, Inc.**

During the year ended December 31, 2008, Lehman Brothers Holdings, Inc. ("LBHI") and certain of its affiliates sought protection under the insolvency laws of their jurisdictions of organization, including the United States, the United Kingdom and Japan. The Partnership had entered into swap transactions, securities trades and other transactions with LBHI and its affiliates. At the date of the bankruptcy filing, the Partnership had outstanding swap transactions with Lehman Brothers Special Financing ("LBSF"), an affiliate of LBHI, for which LBHI served as credit support provider. The Partnership had posted collateral amounts in accordance with the swap transactions. As a result of the bankruptcy filing, the Partnership terminated its trades and related agreements with LBSF and has initiated claims for damages. LBSF and LBHI may be unable to fulfill their commitments under the agreement; however the General Partner believes that the financial impact to the Partnership relating to these events is immaterial.

**18. Other Required Disclosure**

For the year ended December 31, 2009, excluding the allocation of carried interest, the ratio of net investment income to average limited partners' capital was 5.2%, the ratio of expenses to average limited partners' capital before and after carried interest was 3.2% and the Limited Partners' total return before and after carried interest was 93.0%.

**19. Subsequent Events**

Management has evaluated the events and transactions that have occurred through March 16, 2010, the date the financial statements were issued, and noted no items requiring adjustment of the financial statements or additional disclosures.

As of January 1, 2010, the Partnership designated approximately 25% of the portfolio. Designated Investments will be managed by the Partnership and will be sold when the Partnership deems to be in the best interest of the Partnership.

During January 2010, the Partnership paid cash withdrawals of \$155,543,238 for amounts included in capital withdrawals payable on the Consolidated Statement of Assets, Liabilities and Partners' Capital.